

Louisiana Law Review

Volume 54 | Number 6

The Civil Rights Act of 1991: A Symposium

July 1994

Reves v. Ernst & Young: Is RICO Corrupt?

J. Todd Benson

Repository Citation

J. Todd Benson, *Reves v. Ernst & Young: Is RICO Corrupt?*, 54 La. L. Rev. (1994)

Available at: <https://digitalcommons.law.lsu.edu/lalrev/vol54/iss6/12>

This Note is brought to you for free and open access by the Law Reviews and Journals at LSU Law Digital Commons. It has been accepted for inclusion in Louisiana Law Review by an authorized editor of LSU Law Digital Commons. For more information, please contact kreed25@lsu.edu.

NOTES

Reves v. Ernst & Young: Is RICO Corrupt?

I. DECISION

In *Reves v. Ernst & Young*,¹ the Supreme Court of the United States addressed the culpability of outside auditors under a provision of the Racketeering Influenced and Corrupt Organizations Act (hereinafter "RICO").² The decision resolved a split in the United States circuit courts as to which test courts should apply to establish liability under 18 U.S.C. § 1962(c).³

Reves, the bankruptcy trustee for a financial company named the Farmer's Cooperative of Arkansas and Oklahoma, Inc. (hereinafter "the Co-op"), brought a class-action suit on behalf of the holders of certain Co-op securities against a predecessor to Ernst & Young,⁴ the Co-op's auditing firm, under 18 U.S.C. § 1962(c). In its 1981 audit of the Co-op, Ernst & Young had overvalued by at least \$3 million a gasohol plant that the Co-op had acquired from a borrower in lieu of repayment of loans made by the Co-op for the construction of the plant. The overvaluation helped hide the Co-op's insolvency, which later became apparent due to the Co-op's filing for bankruptcy protection. Reves sought to hold Ernst & Young liable under the civil liability clause of RICO on the ground that it had "conduct[ed] or participate[d], directly or indirectly, in the conduct of [the Co-op's] affairs" through a pattern of securities fraud.⁵ Reves argued that Ernst & Young had participated in the conduct of the Co-op's affairs through their fraudulent audits.⁶ The trial and appellate courts ruled for the defendants on grounds that audits did not satisfy § 1962(c)'s requirement of participation in the operation or the management of the enterprise.

The Supreme Court affirmed, holding that defendants must participate in the operation or management of the enterprise in order to be subject to liability under 18 U.S.C. § 1962(c).

Copyright 1994, by LOUISIANA LAW REVIEW.

1. 113 S. Ct. 1163 (1993).

2. 18 U.S.C. § 1962 (Supp. V 1993).

3. 18 U.S.C. § 1962(c) (Supp. V 1993) makes it unlawful "for any person employed by or associated with [an interstate] enterprise . . . to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity"

4. Russell Brown & Company was the original named defendant. Russell Brown & Company merged with Arthur Young & Company. Arthur Young & Company then merged with Ernst & Young. *United States v. White*, 671 F.2d 1126 (8th Cir. 1982). For the purpose of simplicity, this note will refer to the accounting firm defendant as Ernst & Young.

5. 18 U.S.C. § 1962(c) (Supp. V 1993).

6. *Reves v. Ernst & Young*, 113 S. Ct. 1163, 1168 (1993).

II. HISTORY

In order to appreciate the reasoning and policy behind the Court's decision in *Reves*, this section will examine the history of Supreme Court RICO jurisprudence. Furthermore, this section will review the different tests that the circuit courts developed to interpret § 1962(c): (1) the *Scotto-Provenzano* test, (2) the *Cauble* test, (3) the "facilitation or utilization" test, and (4) the "operation or management" test.

A. Supreme Court RICO Jurisprudence

Before the *Reves* decision, the Supreme Court had addressed RICO on ten separate occasions.⁷ Early jurisprudence broadened the scope of RICO.⁸ This trend continued through 1985, when the Court provided its first hints as to how RICO might be narrowed.⁹

The Court's first holding against a broad construction of civil RICO occurred in 1987, in *Agency Holding Corp. v. Malley-Duff & Associates, Inc.*¹⁰ The district court in *Agency Holding Corp.* dismissed the plaintiff's RICO claim on the ground that it was barred by Pennsylvania's two-year statute of limitations for fraud. The court of appeal reversed on the ground that a six-year state "catch-all" limitation period was applicable rather than the two-year period for fraud.¹¹ The Supreme Court rejected altogether the lower courts' borrowing of analogous state-law limitation periods, and instead imposed a uniform federal period of four years, based on the Clayton Act's civil enforcement provision.¹²

7. *Holmes v. Securities Investor Protection Corp.*, 112 S. Ct. 1311 (1992); *Tafflin v. Levitt*, 493 U.S. 455, 110 S. Ct. 792 (1990); *H.J., Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229, 109 S. Ct. 2893 (1989); *Caplin & Drysdale, Chartered v. United States*, 491 U.S. 617, 109 S. Ct. 2646 (1989); *United States v. Monsanto*, 491 U.S. 600, 109 S. Ct. 2657 (1989); *Agency Holding Corp. v. Malley-Duff & Assocs., Inc.*, 483 U.S. 143, 107 S. Ct. 2759 (1987); *Shearson Am. Express, Inc. v. McMahon*, 482 U.S. 220, 107 S. Ct. 2332 (1987); *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 105 S. Ct. 3275 (1985); *Russello v. United States*, 464 U.S. 16, 104 S. Ct. 296 (1983); *United States v. Turkette*, 452 U.S. 576, 101 S. Ct. 2524 (1981).

8. See *Russello v. United States*, 464 U.S. 16, 104 S. Ct. 296 (1983) (insurance proceeds received as a result of racketeering activities constituted "interest" within the meaning of the forfeiture provision of RICO); *United States v. Turkette*, 452 U.S. 576, 101 S. Ct. 2524 (1981) ("enterprise" as used in RICO encompassed both legitimate and illegitimate enterprises).

9. In *Sedima, S.P.R.L. v. Imrex Co., Inc.*, 473 U.S. 479, 105 S. Ct. 3275 (1985), the defendant argued that the application of civil RICO should be restricted to persons convicted of a predicate act or RICO violation and that a plaintiff should be required to establish a "racketeering injury," not merely an injury resulting from the predicate acts themselves. The Court refused to restrict civil RICO in this manner, suggesting: (1) elimination of securities mail and wire fraud statutes as predicate acts by Congress or (2) clarification of the pattern requirement by lower courts. Congress never acted on the hint; lower courts did—eventually leading to *H.J., Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229, 109 S. Ct. 2893 (1989).

10. 483 U.S. 143, 107 S. Ct. 2759 (1987).

11. *Agency Holding Corp. v. Malley-Duff & Assocs., Inc.*, 792 F.2d 341 (1986).

12. 15 U.S.C. § 15(b) (Supp. V 1993).

The four-year period adopted in *Agency Holding Corp.* was longer than some state periods, but shorter than others. *Agency Holding Corp.* effectively eliminated the benefits of forum-shopping by plaintiffs who had formerly been able to borrow the longer limitation periods of other states.

The next significant narrowing of civil RICO occurred in *H.J. Inc. v. Northwestern Bell Telephone Co.*¹³ In *H.J., Inc.*, the Court held that RICO's pattern requirement could be satisfied only by proving both "relationship and continuity" among the alleged acts of racketeering.¹⁴ The *H.J., Inc.* test increased the power of lower courts to dismiss RICO claims.

Lastly, in *Holmes v. Securities Investor Protection Corp.*, the Court limited RICO by mandating a direct injury requirement in any civil RICO action.¹⁵ Again, the Court analogized RICO to the Clayton Act and required some direct relation between the injury asserted and the injurious conduct alleged.¹⁶

Although the early decisions of the Court in RICO cases failed to restrict RICO's scope, every case after *Sedima, S.P.R.L. v. Imrex Co., Inc.*¹⁷ in 1985 has done just that. When viewed as the most recent decision in this pattern, *Reves'* further restrictions are not surprising.

B. The Circuit Court Tests

Before *Reves*, lower courts had trouble interpreting the § 1962(c) phrase "conduct or participate in the conduct of the affairs" in much the same way that they had difficulty with the meaning of "pattern" before the Supreme Court's decision in *H.J., Inc.*¹⁸ In *Reves*, as in *H.J., Inc.*, the Supreme Court resolved the issue by allowing the circuit courts to develop different interpretations before finally granting certiorari to resolve the issue. Before *Reves*, the circuit courts had developed four tests interpreting the "conduct the affairs" clause: (1) the *Scotto-Provenzano* test, (2) the *Cauble* test, (3) the "facilitation or utilization" test, and (4) the "operation or management" test.

1. The Scotto-Provenzano Test

In *United States v. Scotto*, Scotto, a union president, was charged with receiving illegal cash payments, in the form of kickbacks, commissions on

13. 492 U.S. 229, 109 S. Ct. 2893 (1989).

14. *Id.* at 250, 109 S. Ct. at 2906. However, the Court refused to read an "organized crime" limitation into RICO's pattern concept. *Id.*

15. 112 S. Ct. 1311, 1318 (1992).

16. *Id.* at 1318-19. But see Dan Shapiro, *Holmes v. S.I.P.C.: Proximate Cause Dims the Bright-Lines of RICO Standing*, 53 La. L. Rev. 1911 (1994) (concluding that a proximate cause analysis is the proper standard, not directness alone).

17. 473 U.S. 479, 105 S. Ct. 3275 (1985).

18. See *Sedima, S.P.R.L. v. Imrex Co., Inc.*, 473 U.S. 479, 105 S. Ct. 3275 (1985).

business, and "Christmas bonuses."¹⁹ The trial court instructed the jury that it was not necessary for the government to prove that the defendant's activities advanced the enterprise, that the enterprise was corrupt, or that the enterprise authorized the defendant's actions. Instead, the jury needed only to find "that the acts were committed by the defendant or caused to be committed by him in the conduct of, or his participation in, the affairs of the enterprise."²⁰

The defendant argued that RICO requires "a sufficient nexus between the predicate misconduct and the conduct of the enterprise"²¹ The court rejected this argument, stating:

We think that one conducts the activities of an enterprise through a pattern of racketeering when (1) one is enabled to commit the predicate offenses solely by virtue of his position in the enterprise or involvement in or control over the affairs of the enterprise, or (2) the predicate offenses are related to the activities of that enterprise.²²

Similarly, the defendant in *United States v. Provenzano*, a union officer, was convicted of extorting money from New Jersey businesses.²³ Provenzano alleged that, although he personally profited from the payoffs, his activities did not advance the interests of the union.²⁴

Provenzano argued the government could not satisfy § 1962(c) unless it could show the enterprise was advanced or benefitted by the pattern of racketeering activity.²⁵ The Third Circuit rejected this argument and adopted the same test as that announced by the Second Circuit in *Scotto*.²⁶

The *Scotto-Provenzano* test is very broad, effectively replacing the "participate . . . in the conduct" language of § 1962(c) with the phrase "takes actions related to." This excludes from RICO's reach only those acts that cannot be considered "related" in some way to the activities of some interstate enterprise.

2. *The Cauble Test*

The Fifth Circuit established its test in *United States v. Cauble*.²⁷ Cauble was convicted of various RICO violations arising from his position as a crime boss in an organization responsible for smuggling over 147,000 pounds of marijuana into the United States over a two-year period. Cauble challenged his

19. 641 F.2d 47, 51 (2d Cir. 1980), *cert. denied*, 452 U.S. 961, 101 S. Ct. 3109 (1981).

20. *Id.* at 54.

21. *Id.* at 53.

22. *Id.* at 54.

23. 688 F.2d 194, 197 (3d Cir.), *cert. denied*, 459 U.S. 1071, 103 S. Ct. 492 (1982).

24. *Id.*

25. *Id.* at 199.

26. *Id.* at 200.

27. 706 F.2d 1322 (5th Cir.), *cert. denied*, 465 U.S. 1005, 104 S. Ct. 996 (1984).

conviction under § 1962(c) on the ground of vagueness, but the court rejected this assertion.

Cauble held that a defendant does not “conduct” or “participate in the conduct” of an enterprise’s affairs “unless (1) the defendant has in fact committed the racketeering acts as alleged; (2) the defendant’s position in the enterprise facilitated his commission of the racketeering acts,[sic] and (3) the predicate acts had some effect on the lawful enterprise.”²⁸ The Seventh and Eighth Circuits have adopted the same test.²⁹

The *Cauble* test purports to have three elements, but, in fact, is a two-prong test. The first element is nothing more than a matter of proof required to establish any RICO violation. The second and third elements are essentially a restatement of the *Scotto-Provenzano* test, except that the two elements are joined in the conjunctive rather than disjunctive. However, there is one problematic change in the language of the test—the use of the word “effect” in place of “related to.” Under the *Cauble* test, a defendant could participate in the conduct of an enterprise’s affairs through a pattern of racketeering activity and, while affecting victims outside of the enterprise, not affect the enterprise itself.³⁰

The *Cauble* test is narrower than the *Scotto-Provenzano* test in two respects. First, the plaintiff or prosecution must satisfy both elements instead of *either* element, as required in *Scotto-Provenzano*. Second, the racketeering acts must affect, and not merely relate to, the enterprise. The “affect the enterprise” portion of the *Cauble* test has been criticized on grounds that it improperly eliminates “outsiders” from the protection of § 1962(c).³¹

3. The “Facilitation or Utilization” Test

The Eleventh Circuit established a “facilitation or utilization” test in *United States v. Carter*.³² Carter, along with nine other named defendants, was charged under RICO with profiting from drug smuggling and bribery.³³ The defendants argued that the government could not meet its burden of proving conduct through

28. *Id.* at 1333.

29. *United States v. Horak*, 833 F.2d 1235 (7th Cir.), *aff’d in part, vacated in part*, 833 F.2d 1235 (1987); *United States v. Ellison*, 793 F.2d 942 (8th Cir.), *cert. denied*, 479 U.S. 937, 107 S. Ct. 415 (1986). *But see Bennett v. Berg*, 685 F.2d 1053, *aff’d*, 710 F.2d 1361 (8th Cir.), *cert. denied*, 464 U.S. 1008, 1104 S. Ct. 527 (1983) (accepting the “operation or management” test).

30. See Melissa Harrison, *Nexus: The Next Test of RICO’s Text*, 70 Denv. U. L. Rev. 69, 76 n.48 (1992) (Giving an example where a police officer solicited and received bribes from an undercover FBI agent. As a result of these bribes the officer “influenced the disposition” in the county courts of certain pending cases. The officer was convicted under § 1962(c). Thus, the court “was not victimized by [the officer’s] conduct, nor did it participate in the bribery, but [the officer] used his position in the court as leverage, as a ‘tool’ through which to carry on his bribery scheme.” *Id.*).

31. See *id.* at 70.

32. 721 F.2d 1514 (11th Cir.), *cert. denied*, 469 U.S. 819, 105 S. Ct. 89 (1984).

33. *Id.* at 1520.

a pattern of racketeering activity under § 1962(c) unless it could prove a relationship between the enterprise and the "illegal activity affecting the common everyday affairs of the enterprise."³⁴ The court rejected this standard and instead adopted the "facilitation or utilization" test.

The focus of the "facilitation or utilization" test, unlike the other tests, was not on the "conduct or participate" clause; instead, it focused on the statutory word "through."³⁵ Nevertheless, the test was designed to resolve the same basic issue—the nexus required under § 1962(c) between an enterprise and the racketeering acts of a defendant.

The *Carter* court rejected the argument that the required nexus is established only if the racketeering acts affect the everyday affairs of the enterprise.³⁶ Instead, the court held the nexus requirement is satisfied when "the facilities and services of the enterprise were regularly and repeatedly utilized to make possible the racketeering activity"³⁷

The Fourth Circuit used the *Carter* approach in *United States v. Webster* (hereinafter "*Webster II*").³⁸ The *Webster* defendants were convicted on RICO charges related to a conspiracy to distribute illegal drugs. The prosecution failed to show that the racketeering activity benefitted the enterprise with which the defendants were associated. However, *Webster II* held that the government established a nexus by proof that the enterprise was "regularly made available to and put in the service of" the racketeering activity.³⁹

The "facilitation or utilization" test has been criticized on grounds that it could be satisfied by a pattern of racketeering activity in which the "enterprise" took no part. If a racketeer used the facilities of an enterprise merely to aid his own racketeering activity, his conduct would satisfy the "facilitation or utilization" test even though the affairs of the enterprise itself were completely unaffected.⁴⁰

4. The "Operation or Management" Test

The Fourth Circuit established the *Reves*-approved "operation or management" test in *United States v. Mandel*.⁴¹ In devising its test, the *Mandel* court

34. *Id.* at 1526.

35. 18 U.S.C. § 1962(c) (Supp. V 1993) makes it unlawful "for any person employed by or associated with [an interstate] enterprise . . . to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity" (emphasis added).

36. *Carter*, 721 F.2d at 1527.

37. *Id.*

38. 669 F.2d 185 (4th Cir.), *cert. denied*, 456 U.S. 935, 102 S. Ct. 1991 (1982). On original hearing, in *United States v. Webster*, 639 F.2d 174 (4th Cir.), *cert. denied*, 454 U.S. 857, 102 S. Ct. 307 (1981), the court required that the racketeering activity benefit the enterprise in some way in order to establish a sufficient nexus. *Id.* at 184.

39. *Webster II*, 669 F.2d at 187.

40. Harrison, *supra* note 30, at 78-79.

41. 591 F.2d 1347 (4th Cir. 1979). *vacated on other grounds*, 602 F.2d 653 (4th Cir.) (en banc)

considered both the purpose of RICO—prevention of the infiltration of legitimate business by organized crime—and the statutory language of § 1962(c), particularly the use of the word “through.” *Mandel* held that the “conduct or participate” language required some involvement in the operation or management of the enterprise.⁴²

The Eighth Circuit accepted the same “operation or management” test in *Bennett v. Berg*.⁴³ *Bennett*, referring to *Mandel*, stated, in dicta,⁴⁴ that a “defendant’s participation must be in the conduct of the affairs of a RICO enterprise, which ordinarily will require some participation in the operation or management of the enterprise itself.”⁴⁵

The D.C. Circuit accepted the “operation or management” test in *Yellow Bus Lines, Inc. v. Drivers, Chauffeurs & Helpers Local 639*.⁴⁶ *Yellow Bus Lines* brought suit under the civil action provision of RICO against a local union and business agent. The RICO claim was based on the defendants’ actions in conducting a strike against Yellow Bus Lines, the strikers’ employer.⁴⁷ The defendant union asserted that it did not “conduct or participate in” the affairs of Yellow Bus Lines.⁴⁸

After an extensive discussion of the various tests and the merits of each, the court held:

The “conduct of [the enterprise’s] affairs” thus connotes more than just some relationship to the enterprise’s activity; the phrase refers to the guidance, management, direction or other exercise of control over the course of the enterprise’s activities. In order to participate in the conduct of an enterprise’s affairs, then, a person must participate, to some extent, in “running the show.”⁴⁹

(per curiam), *cert. denied*, 445 U.S. 961, 100 S. Ct. 1647 (1980).

42. *Id.* at 1375-76.

43. 710 F.2d 1361 (8th Cir.), *cert. denied*, 464 U.S. 1008, 104 S. Ct. 527 (1983).

44. This language was dicta since the court was simply advising the parties as to how to amend their pleadings on remand.

45. *Bennett*, 710 F.2d at 1364.

46. 913 F.2d 948 (D.C. Cir. 1990), *cert. denied*, 111 S. Ct. 2893 (1991).

47. *Id.* at 950.

48. *Id.*

49. *Id.* at 954 (brackets in original). The court explained:

A simple example illustrates [the proper interpretation of “conduct or participate”]. A terrorist who hijacked an airliner to extort money from an airline has committed an act that legally constitutes “racketeering activity” in terms of the RICO definitional section—1961(1) (“extortion”). And certainly this act would meet the literal terms of the Second Circuit’s broad “conduct or participation” test—treating the threatened airline as the enterprise—since the seizure of its airplane is related to its activities of flying, carrying passengers, and engaging in air commerce. Nonetheless, this hardly seems to be what Congress had in mind in enacting RICO. If, on the other hand, a potential RICO defendant hijacks not the airliner but the airline, as for example by either directly or indirectly taking control of its executive management positions, this would seem to be what Congress in fact had in mind in the enactment of the RICO statute.

Despite this rationale, the Eleventh Circuit, in *Bank of America National Trust & Savings Ass'n v. Touche Ross & Co.*,⁵⁰ refused to follow the "operation or management" test.⁵¹ In the Eleventh Circuit's view, the test "ignore[d] the 'directly or indirectly' language of § 1962(c)."⁵² *Bank of America* concluded that "[t]he substantive proscriptions of the RICO statute apply to insiders *and outsiders*—those merely 'associated with' an enterprise—who participate directly *and indirectly* in the enterprise's affairs through a pattern of racketeering activity The RICO net is woven tightly to trap even the smallest fish, those peripherally involved."⁵³

III. THE CASE

A. Factual Background

In *Reves*, the Co-op acquired White Flame Fuels, Inc., a gasohol manufacturing company that was owned by the Co-op's long-time general manager, Jack White. White had borrowed roughly \$4 million from the Co-op to finance the construction of White Flame's gasohol plant, and transferred the company to the Co-op in satisfaction of his indebtedness. Although White Flame had invested \$4.5 million in the gasohol plant, the plant was worth only \$444,000 to \$1.5 million at the time the Co-op acquired White Flame from White.⁵⁴

After White's conviction for tax fraud in 1981,⁵⁵ the Co-op retained a predecessor to defendant Ernst & Young⁵⁶ to perform an audit. In connection with the audit, Ernst & Young placed a value on the gasohol plant based solely on its consultations with White, a convicted felon, and its review of White Flame's books, which had been prepared by another convicted felon, Gene Kuykendall.⁵⁷ The *Reves* opinion succinctly describes Ernst & Young's valuation decision:

Id. at 955.

50. 782 F.2d 966 (11th Cir. 1986).

51. Ironically, the Eleventh Circuit's rejection of the "operation or management" test occurred in a case strikingly similar to *Reves*, the case in which it finally prevailed. In the Eleventh Circuit case five banks that had provided financing for a later-bankrupt corporation sued the accounting firm and accountants who had prepared the required financial statements for the corporation, alleging several RICO violations. The defendants argued that the banks had failed to allege a sufficient nexus between the defendants and the corporation. The Eleventh Circuit rejected this assertion, which was essentially the same assertion that was later accepted in *Reves*.

52. *Bank of America*, 782 F.2d at 970.

53. *Id.* (quoting *United States v. Watchmaker*, 761 F.2d 1459, 1476 (11th Cir.), *cert. denied*, 474 U.S. 1100, 106 S. Ct. 879 (1986)).

54. *Reves v. Ernst & Young*, 133 S. Ct. 1163, 1167 (1993).

55. *United States v. White*, 671 F.2d 1126 (8th Cir. 1982).

56. Russell Brown & Company was the firm retained. See *supra* note 4.

57. *United States v. White*, 671 F.2d 1126 (8th Cir. 1982).

If the Co-op had owned White Flame from the beginning of construction in 1979, White Flame's value for accounting purposes would be its fixed-asset value of \$4.5 million. If, however, the Co-op had purchased White Flame from White, White Flame would have to be given its fair market value at the time of purchase, which was somewhere between \$444,000 and \$1.5 million. If White Flame were valued at less than \$1.5 million, the Co-op was insolvent. [The auditor] concluded that the Co-op had owned White Flame from the start and that the plant should be valued at \$4.5 million on its books.⁵⁸

In April of 1982, Ernst & Young presented its audit to the Co-op's board, without informing the board of its decision regarding the ownership and valuation of White Flame.⁵⁹ However, Ernst & Young did note in the financial statements that it doubted whether the Co-op could ever recover its investment in White Flame and that White Flame was sustaining operating losses averaging \$100,000 per month.⁶⁰

In May of 1982, the Co-op held its annual shareholders' meeting. At that meeting, a partner from Ernst & Young passed out condensed financial statements, which included White Flame's \$4.5 million asset value.⁶¹ However, the condensed statements contained no other information relevant to White Flame. The only relevant information concerning White Flame presented at the meeting was that the plant had incurred approximately \$1.2 million in losses.⁶² Virtually the same events unfolded at the 1983 annual meeting.

In February 1984, the Co-op experienced a run on its demand notes.⁶³ An inability to secure further financing forced the Co-op into bankruptcy. The bankruptcy resulted in the demand notes being frozen, no longer redeemable at will by their holders.⁶⁴

In February 1985, Reves, the bankruptcy trustee for the Co-op, filed a class-action suit on behalf of the holders of the Co-op's demand notes against forty individuals and entities, including Ernst & Young.⁶⁵ The trial court granted summary judgment for Ernst & Young on the RICO claim on the grounds that Ernst & Young had not conducted or participated in the conduct of the affairs of the Co-op.⁶⁶ The Ninth Circuit affirmed on the same grounds,⁶⁷ and the Supreme Court granted certiorari.

58. *Reves*, 113 S. Ct. at 1167.

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.* at 1167-68.

63. When investors realized that the Co-op was insolvent, they attempted to liquidate the notes in order to recover their investments.

64. *Reeves v. Ernst & Young*, 113 S. Ct. 1163, 1168 (1993).

65. *Id.* All parties except Ernst & Young settled before trial.

66. *Id.*

67. *Reves v. Ernst & Young*, 937 F.2d 1310 (9th Cir. 1991).

B. The Majority Decision

The Court analyzed the statutory language of § 1962(c), the legislative history of § 1962(c), and RICO's "liberal construction" clause⁶⁸ to reach its decision adopting the "operation or management" test.

The Court began its analysis in *Reves* by examining the language of the statute.⁶⁹ Section 1962(c) makes it unlawful "for any person employed by or associated with [an interstate] enterprise . . . to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity"⁷⁰ First, the Court examined the word "conduct" both as a verb in the phrase "to conduct the affairs" and as a noun in the phrase "to participate in the conduct of" Because § 1962(c) uses "conduct" twice,⁷¹ the majority concluded that it was reasonable to give each use a similar construction, relying in both instances on *Webster's Third New International Dictionary*.⁷² In its first use, the majority concluded the word "conduct" was a verb meaning to "lead, run, manage, or direct."⁷³

Reves argued that the Court should read "conduct" as "carry on," resulting in a broad interpretation of § 1962(c).⁷⁴ The majority rejected this argument on the ground that the context of "conduct" in the phrase "to conduct . . . [an] enterprise's affairs" indicates "some degree of direction."⁷⁵ The majority concluded that, both as a verb and as a noun, "conduct" requires an element of direction; otherwise, it is superfluous.⁷⁶

Next, the majority wrestled with the meaning of the phrase "participate in the conduct," which it conceded was a more difficult question.⁷⁷ The plaintiffs argued that since the Court had previously characterized "participate" as a "term of breadth,"⁷⁸ the Court should construe it as a synonym for "aid and abet."⁷⁹ The Court rejected this argument on the ground that such an interpretation would broaden § 1962(c) beyond its intended scope.⁸⁰ Relying on its earlier interpre-

68. 18 U.S.C. § 1961 (Supp. V 1993).

69. Statutory language analysis is common in Supreme Court interpretations of RICO. See, e.g., *Russello v. United States*, 464 U.S. 16, 20, 104 S. Ct. 296, 299 (1983); *United States v. Turkette*, 452 U.S. 576, 580, 101 S. Ct. 2524, 2527 (1981).

70. 18 U.S.C. § 1962(c) (Supp. V 1993) (emphasis added).

71. "[T]o conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs." 18 U.S.C. § 1962(c) (Supp. V 1993) (emphasis added).

72. *Reves v. Ernst & Young*, 113 S. Ct. 1163, 1169 (1993).

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.* ("Congress could easily have written 'participate, directly or indirectly, in [an] enterprise's affairs,' but it chose to repeat the word 'conduct.'") The dissent attempted to narrow "conduct" by applying its definition as a noun. See *infra* Section III(C).

77. *Reves v. Ernst & Young*, 113 S. Ct. 1163, 1170 (1993).

78. *Russello v. United States*, 464 U.S. 16, 21-22, 104 S. Ct. 296, 299 (1983).

79. *Reves*, 113 S. Ct. at 1170.

80. *Id.*

tation of the verb "conduct" as meaning "manage or direct," the Court concluded that "in order to 'participate, directly or indirectly, in the conduct of such enterprise's affairs,' one must have some part in directing those affairs."⁸¹

The majority next confirmed its interpretation of the statutory language by reviewing the legislative history of the RICO provision in question.⁸² The Court noted that § 1962(c) was an amendment to the original Criminal Activities Profits Act which imposed liability only if a defendant "participated as a principal" in an enterprise.⁸³ Congress subsequently amended 18 U.S.C. § 1623 "to prohibit the infiltration or management of legitimate organizations by racketeering activity or the proceeds of racketeering activity."⁸⁴ This amendment became § 1962(c).

The debate from the floor of Congress indicates that the members understood § 1962(c) to include a prerequisite of participation in the operation or management.⁸⁵ There was concern emanating from the bill's critics that the statute defined "racketeering" so broadly that it could be used against legitimate business organizations.⁸⁶ Senator McClellan, a supporter of RICO, assured Congress that this was not the case, stating that a defendant must engage in a pattern of racketeering and "use[] that pattern to obtain or operate an interest in an interstate business" in order to be made subject to the RICO provisions.⁸⁷

The majority next examined the impact of RICO's "liberal construction" clause.⁸⁸ The Court gave the clause short shrift, stating that it would not use the "liberal construction" clause "to apply RICO to new purposes that Congress never intended."⁸⁹ The majority concluded that these new purposes should instead be gleaned from the statute through interpretation.⁹⁰

81. *Id.* The Court explained that RICO liability was not limited to persons who held some formal position in the enterprise. Even though RICO covers both direct and indirect participation, there is no liability under § 1962(c) unless the defendant took "some part in directing the enterprise's affairs." *Id.*

82. *Id.* The Court often uses legislative history to interpret RICO. *See, e.g.,* *Holmes v. Securities Investor Protection Corp.*, 112 S. Ct. 1311, 1317 (1992); *H.J., Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229, 238, 109 S. Ct. 2893, 2900 (1989); *Agency Holding Corp. v. Malley-Duff & Assocs., Inc.*, 483 U.S. 143, 151, 107 S. Ct. 2759, 2764 (1987); *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 486, 105 S. Ct. 3275, 3280 (1985). In *Reves*, Justices Scalia and Thomas refused to join the majority in examining the legislative history, since, in their view, the language of § 1962(c) was sufficiently clear to resolve the dispute between the parties. Presumably, this was based on their philosophy of the "new textualism," which provides that judges consult legislative history only if the language of the statute is not only ambiguous, but ridiculous. *See* Harrison, *supra* note 30, at 102-04.

83. *Reves v. Ernst & Young*, 113 S. Ct. 1163, 1170 (1993).

84. *Id.* at 1171.

85. *Id.* at 1172.

86. *Id.*

87. *Id.*

88. Congress directed, by Pub. L. 91-452, § 904(a), 84 Stat. 947, that the "provisions of this title shall be liberally construed to effectuate its remedial purposes."

89. *Reves v. Ernst & Young*, 113 S. Ct. 1163, 1172 (1993).

90. *Id.*

The majority concluded that the "operation or management" test is the proper standard to be used to interpret § 1962(c) based on statutory language and legislative history. Furthermore, the majority refused to accept a broad interpretation of § 1962(c) even in light of RICO's "liberal construction" clause.

C. *The Dissent*

The dissent criticized the majority on several grounds, including its statutory language analysis, legislative history analysis, and application of the "liberal construction" clause.

Justice Souter, writing for the dissent, began by suggesting that the meaning of the word "conduct" was not as clear as the majority asserted.⁹¹ Since the meaning is ambiguous, he concluded that the Court should use the "liberal construction" clause to resolve the ambiguity.⁹² Furthermore, he asserted that the context of the word "conduct" precludes the majority's restrictive interpretation.⁹³

The dissent also addressed the majority's legislative intent analysis in a footnote, arguing that when members of Congress used the word "operation" during its debate, "operation" was simply a "shorthand method" of referring to the "participate . . . or conduct the affairs of" language of § 1962(c).⁹⁴ This "shorthand," the dissent asserted, was not meant to clarify the statutory interpretation dilemma at issue in this case.⁹⁵

The dissent asserted that, since "conduct" is not clear and unambiguous, the Court should apply the "liberal construction" clause. If applied, the "liberal construction" clause would recognize the more inclusive definition of the word "conduct," free of any restricting element of direction or control.

Lastly, the dissent asserted that the Court should look to the Code of Professional Conduct developed by the American Institute of Certified Public Accountants to define exactly what an auditing firm must do to "operate or manage" the enterprise it is auditing.⁹⁶ However, the majority held that the "operation or management" test does not incorporate the Code of Professional Conduct into its provisions and professional accounting standards should have no bearing upon the interpretation of § 1962(c).⁹⁷

91. *Id.* at 1174 (Souter, J., dissenting).

92. *Id.* (Souter, J., dissenting).

93. *Id.* at 1175 (Souter, J., dissenting).

94. *Id.* at 1174 n.1 (Souter, J., dissenting).

95. *Id.* (Souter, J., dissenting).

96. *Id.* at 1176 (Souter, J., dissenting). The Code of Professional Conduct is a self-imposed standard (by the accounting profession) by which accountants and auditors agree to abide. However, the Code is not legislation and there is no civil or criminal remedy for its violations.

97. *Id.* at 1174 (Souter, J., dissenting).

IV. CRITICISM

A. *Vagueness Replaces Vagueness*

The Court held "that 'to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs,' one must participate in the operation or management of the enterprise itself."⁹⁸ In effect, the majority test replaces the word "conduct" with the words "operate" and "manage."

The words "operate" and "manage" provide no more guidance than the original language of the statute. *Webster's Third New International Dictionary* defines "operate" as "vi. 1: to perform a work or labor: exert power or influence: produce an effect . . . vt. 1: to cause to occur: bring about by or as if by the exertion of positive effort or influence: initiate; 2: . . . b. to manage and put or keep in operation whether with personal effort or not . . ."⁹⁹ "Manage" is defined as "vt. . . . 2: to control or direct: handle either well or ill: cope with: conduct, administer; vi. . . . 2a: to direct or carry on business or affairs: supervise, administer . . ."¹⁰⁰ It seems unlikely that anyone could find more guidance from "operate" or "manage" than they could from "conduct" or "participate in the conduct of."

B. *The Majority Gives Little Guidance*1. *What the "Operation or Management" Test Does Not Mean*

Just as the words "operate" and "manage" provide little guidance to lower courts and litigants, the "operation or management" test does little to provide a clear standard to be used in cases involving § 1962(c). However, one might be guided by examining what the "operation or management" test does not mean.

The Court, in adopting the "operation or management" test, rejected the other three tests—the *Scotto-Provenzano* test, the *Cauble* test, and the "facilitation or utilization" test—which all interpreted § 1962(c) more broadly.¹⁰¹ Therefore, the broadest interpretation of § 1962(c) under the "operation or management" test must be narrower than an interpretation of § 1962(c) under the *Scotto-Provenzano*, *Cauble*, or "facilitation or utilization" tests.

Furthermore, the "operation or management" test must be interpreted by the lower courts to exclude a fact pattern similar to the one in *Reves*. A lesser involvement with an enterprise than the amount of involvement by Ernst & Young must, necessarily, fail to satisfy the "operation or management" test.

Lastly, the "operation or management" test does not mean what the dissent argued it should mean. The fact that accountants view certain actions as

98. *Id.* at 1173 (citation omitted).

99. *Webster's Third New International Dictionary* 1580-81 (1981).

100. *Id.* at 1372.

101. The Court acknowledged in a footnote that the "operation or management" test is the most narrow of the circuit court tests. *Reves*, 113 S. Ct. at 1172 n.8. The Court further noted that, in a criminal prosecution under § 1962(c), the "rule of lenity" would require it to adopt the most narrow interpretation of the statute. *Id.*

"management" rather than auditing functions is, according to the majority opinion, irrelevant to what Congress meant when it used the word "conduct" or what the Court itself meant when it used the word "manage."

2. What the "Operation or Management" Test Might Mean

How narrow the "operation or management" test is remains an open question. By failing to provide guidance on exactly what the "operation or management" test means, the Court effectively leaves the issue to the lower courts for resolution.¹⁰² This is where the vagueness of the "operation or management" test becomes problematic.

Reves holds that outside auditors, in their usual role, cannot be held liable under § 1962(c), unless the auditor "participate[s] in the operation or management of the enterprise itself."¹⁰³ The "operation or management" test protects outside auditors performing the traditional audit function; it protected Ernst & Young, which went well beyond the traditional auditing function. *Reves* may also protect accountants in roles that go well beyond these traditional auditing

102. As of April 1, 1994, at least two appellate courts cases had elucidated what the "operation or management" test might mean.

In *Baumer v. Pachl*, 8 F.3d 1341 (9th Cir. 1993), the court held that the plaintiff failed to allege a § 1962(c) cause of action under the "operation or management" test. The facts of *Baumer* indicate that Pachl, an attorney for a limited partnership which conducted illegal sales of unregistered securities, was involved in a fraudulent scheme. *Id.* at 1342. The court went on to say:

Pachl's involvement, the preparation of two letters . . . , the preparation of a partnership agreement . . . , and assistance in a . . . Chapter 7 proceeding, in which he again sent two letters, does not suffice to impart liability under *Reves*. The allegedly fraudulent scheme began in 1976 and continued until 1987; Pachl's involvement did not begin until 1982 and his role thereafter was at best sporadic. Pachl at no time held any formal position in the limited partnership. Nor did he play any part in directing the affairs of the enterprise. Pachl's role was limited to providing legal services to the limited partnership and EPA. Whether Pachl rendered his services well or poorly, properly or improperly, is irrelevant to the *Reves* test. We are therefore compelled to conclude that under the *Reves* "operation or management" test the complaint fails to allege a § 1962(c) cause of action as to Pachl.

Id. at 1344.

In *Stone v. Kirk*, 8 F.3d 1079 (6th Cir. 1993), investors who had purchased interests in a joint venture in reliance on representations of the defendant, Kirk, brought suit under § 1962(c). The court stated:

Mr. Kirk was associated with the [joint venture] entity as a sales representative, just as [Ernst &] Young was associated with the *Reves* co-op as an auditor. Mr. Kirk engaged in a pattern of racketeering activity when he repeatedly violated the anti-fraud provisions of the securities laws, just as [Ernst &] Young did. But Mr. Kirk, like [Ernst &] Young, did not participate in the "operation or management" of the RICO entity with which he was associated—and because he was not a participant in the operation or management of the [joint venture] entity, and had no part in directing its officers, Mr. Kirk cannot be held liable under § 1962(c).

Id. at 1081-1083.

103. *Reves*, 113 S. Ct. at 1172. It should be noted that this case may go even further; outside auditors may *never* be liable under § 1962(c) given the factual situation in *Reves*. It is difficult to envision a scenario where *outside auditors* could "cross the line," if Ernst & Young did not.

functions, since Ernst & Young was well beyond these traditional auditing functions. Therefore, the "operation or management" test greatly decreases the probability that an outside auditor will be found liable under § 1962(c).

The "operation or management" test could also have a profound effect upon the civil RICO liability of attorneys and accountants. Since attorneys and accountants rarely "operate or manage" an enterprise *in their roles as attorneys or accountants*, the "operation or management" test is favorable to them.

Attorneys and accountants act primarily as advisors to those who are the true operators and managers. However, the advice these attorneys and accountants dispense is only advice; the operators and managers of the enterprise are not bound to follow it. As a result, simple advice, even if it is bad or illegal, should not subject the attorney or accountant to civil RICO liability.¹⁰⁴

This does not mean that accountants and attorneys can escape liability under § 1962(c) if they are also operators or managers of an enterprise, either formally or informally. For example, one who is both an officer and general counsel could escape liability as general counsel under the "operation or management" test, but *as an officer of the enterprise* would be held liable under the same test. Similarly, a lawyer who in fact exercised the powers of a business executive, without taking office formally, could still be held liable.

However, the Court leaves open a more difficult question. What level of familiarity and communication will cause accountants or attorneys to "cross the line" into "operation or management" and become *de facto* directors? For example, would the "operation or management" test implicate an accountant or attorney who, lacking actual authority, conceives and implements, at the behest of the directors of the enterprise, a racketeering scheme? How does the "operation or management" test affect a professional whose relationship with the enterprise is so familiar that it is difficult to determine where actions of the professional end and actions of the enterprise begin? These questions are not answered in *Reves*. They can only be answered by the courts through future litigation, or by Congress through a clarification of the RICO statute.

V. CONCLUSION

In *Reves*, the Court grappled with a statute that was deliberately made ambiguous by its drafters.¹⁰⁵ This fact makes a decision by any court difficult and subject to criticism.

104. See *supra* note 102.

105. Whether RICO is unconstitutional due to vagueness is beyond the scope of this paper. However, it is questionable whether the Court would uphold RICO if it were challenged on grounds of unconstitutional vagueness. The only current member of the Court to address this issue, Justice Scalia, stated in a concurring opinion:

No constitutional challenge to this law has been raised in the present case, and so that issue is not before us. That the highest Court in the land has been unable to derive from this statute anything more than today's meager guidance bodes ill for the day when that challenge is presented.

H.J., Inc. v. Northwestern Bell Tel. Co., 492 U.S. 229, 255, 109 S. Ct. 2893, 2909 (1989) (Scalia, J., concurring).

Logically, one might argue that if RICO was designed to stop the infiltration of legitimate business enterprises by racketeers, then Congress was probably concerned with the exercise of ownership and managerial powers in interstate enterprises, and not with all racketeering that merely had some connection to these interstate enterprises. If that is so, then the "operation or management" test adopted in *Reves* is a good one. It requires the exercise of some type of managerial authority, while the other circuit court tests (*Scotto-Provenzano*, *Cable*, and "facilitation or utilization" tests) would lead to much broader forms of liability.

However, as the dissent demonstrates, a court could also interpret the words of the statute to favor one or more of the broader tests. Despite the majority's argument, neither the statutory language nor the legislative history provides clear guidance on this important issue.

The uncertainties in RICO are not the fault of the Court. Because of RICO's broad and ambiguous scope, the courts are frequently forced to make legislative policy choices concerning this extraordinarily powerful and pervasive federal statute. Congress is allowing, even requiring, the judiciary to assume Congress' role in determining the depth and breadth of far-reaching federal legislation, and the balance of power between the states and the national government. This is not a task that the judiciary should undertake. Although it may be politically unpopular to clarify or amend a statute that prosecutors use so successfully in fighting organized crime and drug trafficking, both the courts and Congress would benefit from Congressional clarification of the RICO statute.

*J. Todd Benson**

* The author would like to thank Professor Glenn G. Morris for his guidance and assistance. Also, the author would like to thank Charles F. Seemann III and Jennifer A. Bailey for their proofreading and constructive(?) criticism.